No. 2957.

United States Circuit Court of Appeals,

FOR THE NINTH CIRCUIT.

Wm. H. Moore, Jr. *Appellee,* *vs.* National Bank of Bakersfield, et al., *Appellants.*	A-32
Wm. H. Moore, Jr., *Appellee,* *vs.* National Bank of Bakersfield, *Appellant.*	B-94

PETITION FOR REHEARING.

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We respectfully urge that, in the learned opinion announced in the cases at bar, the court has, we believe, inadvertently fallen into the same error as did the trial court, with the result that the decision announced is not "the judgment of the law on the matter contained in the record." We shall endeavor to point out several reasons why the decrees of the District Court should be reversed—and not affirmed.

The equity of appellant's position requires us, preliminarily, to remind the court that the moneys sought to be recovered herein are the proceeds of property which was the *very product* of the defendant bank's loans—property which was acquired, and *only* could have been acquired, by Bannister by means of those loans—[Tr. pp. 187-194], also that those loans were made only upon the express agreement of the parties that the bank was to have a lien upon the property purchased therewith. [Tr. pp. 236.] In such a case the courts are loath to permit the intentions of the parties (honestly expressed at the time of the transactions in question) to be defeated by a trustee in the interests of general creditors who, obviously, have not been injured by the transactions nor as diligent as the defendant in protecting their claims. As was stated *In re* Automobile etc. Co., 176 Fed. 792:

> "There is always a strong equity in favor of a lien by one who advances money upon the property which is the product of the money so advanced. This was what the parties intended at the time, and to this, as already stated, there is and can be no objection in law or in morals." (Quoting Sabin v. Camp, 98 Fed. 974.)
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> 176 Fed. 795.

Clearly, this is a case in which the trustee should be held to a strict compliance with the unquestioned rule of law requiring the trustee to sustain the burden of proving each element of a voidable preference. We venture to assert, with confidence in our contention, that the record here demonstrates the utter failure of the trustee to sustain that burden in several particulars.

A dominant purpose of the bankruptcy act is to effect the equal distribution of the bankrupt estate among those creditors *only* who have established their claims against the estate in the manner provided by that act. Section 57 of the Act provides for the proof, adjudication and allowance of creditors' claims and authorizes a trustee to recover any dividend paid upon a claim which, upon a reconsideration, has been rejected; while section 65 directs the declaration of dividends "on all *allowed* claims"; again the right to vote at the election of the trustee is, by section 56a, restricted to those creditors whose claims have been *allowed* by the referee, and section 66 provides that when all *allowed* claims have been paid, the balance of the estate shall be paid to the bankrupt. Where no claims are allowed, there are no dividends to be paid by the trustee, and in the absence of proof of any allowed claims the *sufficiency* of the assets is manifest.

The objection that the trustee failed to prove a deficiency of assets is not merely a technical one, for such proof constitutes not only a material, but an essential, element of a voidable preference, without proof of which the action must fail. To hold (as the opinion announced herein inferentially does) that this essential element has been established upon the mere showing, by the testimony of the bankrupt alone, that he was heavily indebted at the time the petition was filed, but that he also at the same time owned considerable property which he valued at more than his alleged debts aggregated, is to permit the trustee (upon the mere statement of the bankrupt that creditors exist)

to avoid transactions (valid except for the intervention of bankruptcy proceedings) and thereby to recover property which he cannot distribute to any of those creditors until they have *proven* their claims before the referee, which may never be and often is not done, and which cannot be so proven by the bankrupt's statements alone.

That this element of "deficiency of assets" must be established by the *record of the referee* appears to be well settled.

> Leavengood v. McGee, 91 Pac. 453, 50 Ore. 233:
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> "But a method is provided by the procedure in bankruptcy whereby the claims of creditors may be legally adjudicated, and before the trustee should be permitted to attack by a suit in equity the conveyance of the bankrupt, he shall allege and prove by the *record of the referee* that such procedure has been followed, and that the claims on which he bases his contention have been ascertained and established."
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> 91 Pac. 455.

> Mayhew v. Tobisman (Mo. 1912), 151 S. W. 436, 438:
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> "Admitting that the conveyances under which the defendant claims are fraudulent, no right to avoid them exists, unless the property is needed to pay the claims filed against the bankrupt debtor; and this should be shown affirmatively by the petition. Mueller v. Bruss, 112 Wis. 406, 88 N. W. 229; Prescott v. Gallucio, 21 Am. Bankr. Rep. 229 (D. C.), 164 Fed. 618."

McKey v. Smith (Ill. 1912), 99 N. E. 695, 696:

"There was neither allegation nor proof that any claims of creditors had been allowed in the bankruptcy proceedings. In an ordinary bill of this character it is essential to the maintenance of the suit that the complainant shall have reduced his claim to judgment. No such requirement exists where a trustee in bankruptcy brings such a suit under the Bankruptcy Act, but it is essential that he show by his bill that the assets are insufficient to satisfy the claims of creditors. The trustee can only apply the assets upon *allowed claims.* If the assets in his hands are sufficient to pay *such claims,* there is no reason for the exercise of the equitable jurisdiction to set aside, as fraudulent, conveyances of property to third persons. Conveyances which may be set aside because they are constructively fraudulent as to creditors are valid between the parties, and under the Bankruptcy Act are valid against all persons except those entitled to share in the proceeds of such property—that is, *creditors whose claims have been allowed under the Act.* Unless it appears from the allegations and proof that the property so conveyed is needed to pay such claims, the trustee, whose rights are not superior to those of the creditors he represents, has no right to have such convevance set aside."

Mueller v. Bruss (Wis. 1901), 88 N. W. 229, 231:

"3. A third proposition is that the trustee cannot maintain this action unless it is shown by the complaint that he has not sufficient assets in his hands to satisfy the claims of the creditors of the

debtor. No such showing is made in the complaint. *For all that appears therein, there may be money and property enough in his hands to pay every claim filed against the debtor.* The conveyances attacked were good between the parties thereto. Ellis v. Land Co., 108 Wis. 313, 84 N. W. 417. Third parties are not allowed to impeach them unless it is necessary to do so in order that justice may be done. The trustee has no right superior to that of the creditors he represents. If we admit that the facts stated show such transfers to have been fraudulent, still no right to avoid them exists unless it appears that some one was harmed. It seems quite evident, without argument, that, unless it is made to appear that the property so conveyed is needed to pay the claims filed against the debtor, the trustee has no right to set such conveyances aside. The complaint is insufficient in this respect. It ought to show the amount of claims filed, and the value of the assets in his hands, so that the court may determine the necessity of resorting to this proceeding."

Roney v. Conable (Ia. 1904), 101 N. W. 505:

"Per Curiam: The petition does not state, in substance or effect, that the property of the estate in the trustee's hands is *insufficient to pay the debts proved against the bankrupts.* Neither is there any evidence in the record to show such deficiency. In the absence of both allegation and proof of this material fact, we think the law is well settled that plaintiff is not entitled to a decree. The case of Deland v. Bank, 119 Iowa 368, 93 N. W. 304, seems to be directly in point upon this proposition."

Crary v. Kurtz (Ia. 1906), 105 N. W. 590, 593:

"But this does not obviate the necessity of the administrator, assignee, or trustee in bankruptcy in such a case alleging and proving that claims of creditors have been filed and allowed as contemplated by law. He may question the bona fides of the transfer of the debtor's property *in the interest of those creditors only to whom he may distribute the estate which shall come into his hands. That outstanding obligations exist is not enough.* Unless these are established and allowed, as authorized by statute or the act of Congress, he has no authority to pay them from moneys that may come in his hands, to say nothing of the property the debtor has transferred to others. And, unless it appears that the representative of the creditors may appropriate the proceeds of property in the hands of third parties to the satisfaction of the debtor's obligations, setting aside transfers to them as fraudulent would be of no practical advantage."

Shelley v. Nolen (Texas 1905), 88 S. W. 524, 530:

"We are of opinion that under the provision of the bankruptcy law authorizing this suit it is required that the petition should allege the amount of the claims of the creditors who were such at the time the fraudulent conveyances were made, and that the assets of the bankrupt estate in the hands of the trustee were insufficient to pay same, and these allegations should be supported by proof. *In re* House, 4 Am. Bankr. Rep. 603, 103 Fed. 616; Mueller v. Bruss (Wis.), 8 Am. Bankr. Rep. 447, 88 N. W. 229."

Lesser v. Bradford Realty Co. (N. Y. 1905), 95 N. Y. Sup. 933:

"As to the other points raised, my conclusion must be that the complaint is insufficient. It has been directly held that the trustee's right to maintain such an action as this depends upon the fact that he has not sufficient assets in his hands to satisfy the claims of the creditors; the reason for the rule being that, since the transfer is good as between the parties to it, the transaction should not be set aside at the instance or for the benefit of third parties, unless it is necessary that they be heard in the interests of substantial justice.

* * * * * * * *

Directly to the same effect is the case of Deland v. Miller & Cheney Bank (Iowa), 11 Am. Bankr. Rep. 744, 93 N. W. 304, *and I do not find that the rule stated in these cases has ever been questioned.*"

While in Gering v. Leyda, 186 Fed. 110, 112, the Circuit Court of Appeals (8th Circuit) held it was not necessary *in that case* for the trustee to allege and prove that claims of creditors had been allowed against the bankrupt estate, it must be noted that the facts there under consideration were such that the opinion there announced in no way contravenes the general rule established by the authorities hereinbefore cited. for (quoting from the opinion):

"The trustee's petition alleged that at the time of the transfer in question the bankrupt 'was hopelessly insolvent, and that his indebtedness amounted to *over $24,000,*' and that *'the only* exempt *property* then *owned by him* was the stock of merchandise conveyed to plaintiffs in error."

A "deficiency of assets" was manifest when it was alleged and proved that the *only* property owned by the bankrupt was that sought to be recovered by that action, for there must have been at least three creditors with provable claims in order to have filed the petition and some creditors must have proven their claims in order to have elected a trustee, while the bankrupt estate had *no* assets other than the property sought to be recovered by that action. A different situation is presented, however, when the bankrupt possesses property (as did Bannister) other than that sought to be recovered by the action. A like ruling was also adopted by the District Court of West Virginia in *In re* Schoenfield (190 Fed. 53, 62), but for a similar reason, however.

> "The bankrupt under oath has listed in his schedules debts to the amount of $14,000 and declared himself to have *no assets,* therefore it was not incumbent upon the trustee in his petition to allege, nor, by evidence prove, 'that he has not sufficient assets in his hands to satisfy the claims of the creditors of Herman Schoenfield, bankrupt.' "

The record in the cases at bar exhibits a situation entirely different from that presented by the two cases last cited. Bannister scheduled assets to the amount of $59,157.60 and the evidence shows that he had a substantial amount of property even at the reduced valuations placed thereon by plaintiff's witness. Further, the allegation of the complaints [Tr. pp. 11 and 107] that the effect of the enforcement of the alleged preferences will enable the defendant to obtain a

greater percentage of its debt than any other creditor of the same class is but a conclusion of law, and Bannister's statement that his schedule correctly sets forth his indebtedness was not binding on the court or this defendant.

> Grant v. National Bank (N. Y. 1912), 197 Fed. 581:
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> "The complaint contains no direct averment as to the actual amount of unsecured claims owing by the bankrupt. It is alleged that the schedules of the bankrupt show a certain amount of unsecured claims. This is equivalent to a statement that the bankrupt so represents and states, but such statement is in no way binding on the court or defendant, and *the schedules would not be proof or evidence to establish the amount of the indebtedness of the bankrupt as against the defendant. The allegation* that the effect of the enforcement of the judgment will be to enable the defendant herein, the National Bank of Auburn, to obtain a greater percentage of its said debt than other creditors of the same class, *is but a conclusion.*"

Bannister's statement (and there was no other evidence) was not proof that any of the items were legal obligations of the bankrupt estate (some of which, upon the face of the schedule, were outlawed) [Tr. p. 157], or that the referee had allowed, or ever would allow, them as approved claims against the bankrupt estate. For all that appears, and it must be remembered that the burden of proof is upon the trustee, there may have been a number of reasons why the referee would, and did, refuse to allow all of the alleged

debts scheduled. The most that can be said for the record on this point is that at the time the schedule was filed there were certain accounts which *Bannister* considered outstanding and unpaid, but, as was said in Crary v. Kurtz, *supra, "that outstanding obligations exist is not enough."*

Evidence that Bannister was insolvent and that the effect of the enforcement of the transfers in question will result in the defendant's debt being paid in full obviously does not, in the absence of proof of the amount of the assets of the bankrupt estate and of the proven claims which alone are entitled to share therein, sustain the trustee's burden of proving that the property sought to be recovered is necessary to pay claims established in the only method provided for proving them against the bankrupt estate.

Nor does it logically follow, from the fact that creditors are permitted to file claims at any time within a year of the adjudication, that the trustee need not prove by the record of the referee that the property sought to be recovered is *necessary* to pay *allowed* claims. *Unless* and *until* there is a deficiency of assets to pay such claims there is no necessity of, nor authority in the trustee for, resorting to such an action; and the law will not countenance such a proceeding (which in the absence of an established deficiency is not only useless but unwarranted and unjust) merely because creditors having claims, *possibly* provable, *may* some time within the year see fit to avail themselves of the privilege of filing claims, which *if* allowed would result in a deficiency of assets. If, by reason of the

creditors' own delay in taking advantage of the privilege accorded them of filing their claims, the trustee is delayed in bringing such an action, the consequences of such a delay must properly be borne by those whose laches occasioned it, while third parties, whose alleged preferences are perfectly valid in the absence of such deficiency, should not, nor should the bankrupt estate, be subjected meanwhile to expense by reason of litigation which may prove utterly useless.

The record on these appeals is devoid of evidence of the existence of *any allowed claim* against the bankrupt estate. It does not appear but that the trustee has sufficient property in the estate with which to fully discharge every allowed claim.

In order to sustain the burden of proving that the enforcement of the transfers sought to be avoided will operate to the injury of some creditor whom he represents, the trustee must not only show that claims have been proved and allowed against the bankrupt estate, but he must also show the aggregate of such claims and that the amount of the assets of the estate is such that the defendant bank will, by reason of the transfer sought to be avoided, receive on its claim a larger percentage than the creditors whom the trustee represents will thereby receive on their proven claims. While the record does show that the bankrupt owned considerable property, other than that sought to be recovered herein, it does not disclose the amount of the assets of the bankrupt estate; and there is no evidence as to what property the trustee actually received or recovered, nor its valuation, nor what he realized or could realize

thereon out of which to pay allowed claims. Evidence as to what property Bannister claimed to have possessed at or previous to the time he filed his schedule was not proof or evidence of the amount of assets that came into the possession of the trustee, either from the bankrupt or by recovery from third parties; nor was evidence concerning the value of Bannister's property on April 8, and April 23, 1915 (to which dates only was the evidence concerning valuations addressed), either evidence or proof of the value of the assets of the bankrupt estate, or of the amount realized thereon by the trustee out of which to pay allowed claims; nor evidence or proof of the amount of the assets of the estate at the time the transfers were sought to be avoided, to-wit, when the complaints herein were filed, nor at the time of trial. In the absence of proof of either the assets or obligations of the bankrupt estate, it was impossible for the court to determine that the creditors, if any, of the bankrupt estate would be injured by the enforcement of the transfers sought to be avoided.

Another point we consider deserving of reconsideration is the question of whether the defendant had reasonable cause to believe preferences would be effected by recording and enforcing the trust deed and the mortgages covering the automobile and the warehouse building.

As all dealings between Bannister and the defendant bank respecting the transactions in question were conducted through the cashier, Russell [Tr. pp. 148 and 186], the determination of this question involves

an analysis of the evidence as to what Russell knew, and could reasonably have learned had he pursued such inquiries as would have been made by an ordinarily prudent man under the same or similar circumstances. Without here repeating the summary of the evidence on this point, which is fully set forth on pages 16 to 22, both inclusive, of appellant's brief herein (of which summary we respectfully request a reconsideration by the court in this connection), it may be said that the record shows Russell knew Bannister owned, April 8 and 23, 1915, considerable property which Russell considered to be worth, at a fair valuation, a total of $51,200.00 exclusive of his interest in the Los Angeles Hay and Storage Company and his claim against said company of approximately $17,000.00—the amount of the loans made by the Security Trust Company of Bakersfield, and by the defendant, upon portions of Bannister's property indicated that Russell's valuations were not excessive. It further appears that Bannister's liabilities, so far as known to Russell, then aggregated approximately $28,000.00, leaving an equity of $23,200.00 exclusive of his $17,000.00 claim against the Los Angeles Hay and Storage Company, at least a portion of which Bannister had informed Russell he expected to realize. [Tr. pp. 137, 184, 240.] In the opinion announced herein the court was of the opinion that Russell knew, before placing the trust deed and mortgages of record, that Bannister's Hollywood house had been attached and that the Los Angeles Hay and Storage Company was in financial difficulties, and that he (Russell) was

thereby put upon inquiry. We respectfully urge that had Russell pursued such inquiry it would not have reasonably led to knowledge of Bannister's insolvency. The only evidence of the condition of the Los Angeles concern was Bannister's statement [Tr. p. 143] that he thought its liabilities, including his $17,000.00, exceeded its assets by not more than $28,000.00. Included among the liabilities were certain of its notes guaranteed by Bannister. [Tr. p. 167.] Hence Bannister's stockholder's liability, after deducting his claim (he owning about 60 per cent. of its stock, Tr. pp. 135-6), could not exceed $6600.00, while Wells' claim, upon which the attachment had been issued, amounted to $1789.57. [Tr. p. 164.] Therefore, had Russell pursued an inquiry as to the attachment against Bannister and as to the extent of his liability as a stockholder in the Los Angeles concern, he would have found Bannister still solvent, so far as Russell's information went, by a margin of $14,700.00. None of the scheduled items of indebtedness to non-resident creditors and the Bakersfield creditors, except to the amount of $4,000.00 to the latter, were shown to have been known to Russell at any time or to have appeared upon Bannister's books; in fact the contrary was the case. [Tr. p. 240.] Neither was Russell shown to have been put upon inquiry as to their possible existence nor is it reasonable to suppose that Bannister would have conceded his insolvency to Russell, for it appears [Tr. p. 242] that even after the attachment and the failure of the trustee's plan of financing the Los Angeles concern and the recordation of the trust

deed and mortgages, he still maintained to Russell that he was solvent, though they were trying to put him in insolvency; and no doubt he honestly thought so, for at that time he did not know that he was responsible for a stockholder's liability in the Los Angeles concern, and did not find that out until the petition in involuntary bankruptcy was filed on May 5th [Tr. pp. 182-3], and did not consider that the affairs of the Los Angeles concern had anything to do with his Bakersfield business, which he kept segregated at all times. [Tr. p. 169.]

Such a showing was far short of sustaining the trustee's burden of proving the existence on the part of the defendant bank of the element of "reasonable cause to believe" by *"a fair preponderance of all the evidence in the case."* As was said in Tumlin v. Bryan, 165 Fed. 166, 169:

> "Reasonable cause to believe that a preference was intended cannot be held to be proved by circumstances that would merely excite *suspicion.* And circumstances may seem suspicious *after* the bankruptcy occurs that would not appear unusual at the time of their occurrence, and would then have presented no 'reasonable cause' on which to found a belief of intended preference. Merchants and other business men constantly continue to make payments up to the very eve of failure, and it would be disastrous to have them set aside on slight proof or mere suspicion."

Likewise in the leading case of Grant v. National Bank, 97 U. S. 80, 81:

> "Some confusion exists in the cases as to the meaning of the phrase, 'having reasonable cause to believe such a person is insolvent.' *Dicta* are not wanting which assume that it has the same meaning as if it had read, 'having reasonable cause to suspect such a person is insolvent.' But the two phrases are distinct in meaning and effect. It is not enough that a creditor has some cause *to suspect* the insolvency of his debtor; but he must have such knowledge of facts as to induce a reasonable belief of his debtor's insolvency, in order to invalidate a security taken for his debt. To make mere suspicion a ground of nullity in such a case would render the business transaction of the community altogether too insecure. It was never the intention of the framers of the act to establish any such rule. A man may have many grounds of suspicion that his debtor is in failing circumstances, and yet have *no cause for a well-grounded belief* of the fact. He may be unwilling to trust him further; he may feel anxious about his claim, and have a strong desire to secure it,—and yet such belief as the act requires may be wanting. Obtaining additional security, or receiving payment of a debt, under such circumstances is not prohibited by the law. Receiving payment is put in the same category, in the section referred to, as receiving security. Hundreds of men constantly continue to make payments up to the very eve of their failure, which it would be very unjust and disastrous to set aside. And yet this could be done in a large proportion of cases if mere grounds of suspicion of their insolvency were sufficient for the purpose.

"The debtor is often buoyed up by the hope of being able to get through with his difficulties long after his case is in fact desperate; and his creditors, if they know anything of his embarrassments, either participate in the same feeling, or at least are willing to think that there is a possibility of his succeeding. To overhaul and set aside all his transactions with his creditors, made under such circumstances, because there may exist some grounds of suspicion of his inability to carry himself through, would make the bankrupt law an engine of oppression and injustice. It would, in fact, have the effect of producing bankruptcy in many cases where it might otherwise be avoided.

"Hence the act, very wisely, as we think, instead of making a payment or a security void for a mere suspicion of the debtor's insolvency, requires, for that purpose, that his creditor should have some reasonable cause to believe him insolvent. He must have a knowledge of some fact or facts calculated to produce such a belief in the mind of an ordinarily intelligent man."

We do not believe that facts were brought home to the defendant bank such as would put an ordinarily prudent man upon inquiry which, if pursued, would have reasonably led to a knowledge of Bannister's insolvency, to-wit, that the aggregate of his assets at a fair valuation were not sufficient in amount to pay his debts. (*In re* Eggert, 102 Fed. 735.)

Finally, we desire to point out that the situation with respect to the mortgage upon the warehouse building and that upon the automobile is entirely dif-

ferent from that of the various mortgages upon Bannister's stock in trade. Each of the former covered mortgageable property, was given for a valuable present consideration [Tr. pp. 152, 193], and both were recorded April 23, 1915, prior to the bankruptcy proceedings. As to these, it cannot be said either that the property was not capable of being mortgaged, or that there was a substitution or confusion of the mortgaged goods. Thus, we have an express agreement in writing whereby specific mortgageable property is clearly identified as security for a definite obligation, created for a present consideration and in entire good faith, and resulting in an equitable lien, enforceable whether the property is in the hands of Bannister or of third parties, not *bona fide* purchasers for value—to which latter class the trustee in bankruptcy does not belong even under the amendment of 1910 to section 47a of the Bankruptcy Act. As was said in Root Mfg. Co. v. Johnson, 219 Fed. 397:

> "This doctrine of equitable liens is fundamental in equity whenever the intention, bona fides, identity, and segregation appear, without perfection as a common-law pledge by actual possession in the pledgee; and Walker v. Brown, *supra,* is an instructive case for its definition and application. It defines the rule to be (in substance) that an express executory agreement in writing, whereby specific property or a fund is clearly identified to constitute security for a debt or other obligation, creates an equitable lien upon the property or fund, enforceable whether the property is in the

hands of the promisor, or of third parties not *bona fide* purchasers for value."

219 Fed. 406.

Recent cases in which an equitable lien has been upheld as against a trustee in bankruptcy are:

Sexton v. Kessler, 225 U. S. 90, and

Gerecy v. Dockendorff, 231 U. S. 513.

Wherefore, for the reasons here urged, petitioner respectfully prays that the decision of this court affirming the decrees of the district court be set aside, and petitioner granted a rehearing, and that said decrees, and each of them, be reversed.

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The undersigned, counsel for the petitioner, hereby certify that, in their judgment, the foregoing petition for rehearing is well founded, and that it is not interposed for delay.

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